SUPREME COURT, U. S.

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Supreme Court of the United States

October Term, 1969

No. 465

EDWARD SERZYSKO,

Petitioner,

v.

THE CHASE MANHATTAN BANK,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

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Opinions Below

The District Court's opinion is reported at 290 F.Supp. 74. The Court of Appeals' *per curiam* affirmance is reported at 409 F.2d 1360. Because of errors and omissions in Appendix B of the petition, we refer this Court to the District Court's opinion as reported at 290 F.Supp. 74.

The Issue

May an experienced professional actively engaged in advising customers in the purchase and sale of securities, who procures bank loans by fraudulent misrepresentations and misuses the proceeds in violation of the margin regulations, undo his contractual obligations with the bank making the loans when his speculation proves unprofitable?

Statement

Petitioner, an accredited registered representative of the New York Stock Exchange employed by a member firm, sued respondent to recover as damages monies lost by him in speculating in securities with the proceeds of loans aggregating $270,000. The loans were claimed to have been made in violation of section 7 of the Securities and Exchange Act of 1934 and Regulation U of the Federal margin regulations because, contrary to his written and oral representations, he used the loan proceeds to purchase registered stocks. Respondent counterclaimed to recover the unpaid balance of petitioner's indebtedness.

The case was tried before Senior Judge Henry W. Graven, without a jury. After due consideration and a detailed analysis of the facts, the Court dismissed the complaint on the ground that recovery would be contrary to the purpose of section 7 and the margin regulations, and the counterclaim on the ground that even though respondent had no knowledge of petitioner's fraud, it failed to exercise proper diligence.

Both petitioner and respondent appealed and the Court of Appeals unanimously affirmed in a *per curiam* opinion.

The Facts

The decisions below were based on particular facts relating only to this case. The facts were set forth at considerable length in what the Court of Appeals stated was "the thorough and well reasoned opinion of Judge Graven."

Since 1953, petitioner has been an accredited registered representative of the New York Stock Exchange employed by various member firms to render professional advice and services to customers in the purchase and sale of securities.

As a registered representative he handled the accounts of customers, including margin accounts.

When petitioner first approached respondent, he represented that any loans he might make from respondent would be only non-purpose loans (*i.e.*, loans not within the scope of Regulation U). Thereafter, and before making a loan, petitioner executed and signed a "STATEMENT WITH RESPECT TO PURPOSE OF LOAN" in which he represented in writing that his purpose in making the loan was other than the purchase of registered stocks.

In the Fall of 1961 and early 1962, petitioner was urged by respondent to reduce his indebtedness or furnish additional collateral. After receiving margin calls from respondent in April and May 1962, petitioner directed the sale of certain of his collateral and reduced the amount of his loans from $270,000 to $145,000. In May and June 1962, when petitioner failed to meet further margin calls, respondent sold the remaining collateral and applied the proceeds to petitioner's indebtedness. This left an unpaid balance of $14,603.26, subsequently reduced by petitioner to $12,749.49, for which respondent counterclaimed.

The Trial Court found that "The evidence preponderates that the plaintiff knowingly and intentionally, by oral and written statements, deceived the Bank as to the purposes for which he intended to use the proceeds of the loans" (290 F.Supp. at 83), that "he was familiar with Regulation U and knew what would constitute violations of it" (290 F.Supp. at 87) and, further, that "The evidence preponderates that none of the officers of the defendant having to do with the loans had any actual knowledge of the falsity of the plaintiff's statements or his misuse of the proceeds of the loans" (290 F.Supp. at 83).

REASONS FOR DENYING THE WRIT

I

The District Court correctly ruled that to reward petitioner under the circumstances here present would subvert the policy and purpose of the margin regulations.

The Trial Court concluded that petitioner should be denied relief on the ground that recovery would be contrary to the very purpose of section 7 and the margin regulations. It said:

> "If an investor-borrower could by means of false representations and statements mislead a lender into making a loan for the purchasing or carrying of registered securities . . . there would be encouragement for an investor-borrower to engage in the practice which, in substance, would be that so far as the investor-borrower is concerned he could keep the profits if his speculation proved profitable and have the lender bear the loss if the speculation proved unprofitable." (290 F.Supp. at 89)

and

> "It is the view of the Court that to allow the plaintiff to recover in this action would be to encourage rather than discourage deception on the part of investor-borrowers with resulting prejudice to the observance of the margin requirements of the Act." (290 F.Supp. at 89-90)

The District Court's conclusion that the objective of the margin regulations would be subverted by conferring a reward upon professionals in the securities business who knowingly violate and induce violations of the statute is supported by the commentators. 61 Mich.L.Rev. 940, 954 (1963). To the same effect, see *Federal Margin Requirements as a Basis for Civil Liability,* 66 Colum.L.Rev. 1462,

1482-83 (1966). See also *Moscarelli* v. *Stamm*, 288 F.Supp. 453, 458-60 (E.D.N.Y. 1968).

The result below is compelled by numerous decisions in similar circumstances barring recovery under the established doctrines of waiver, estoppel, laches and assumption of risk, which have long been recognized as applicable in civil actions under the securities acts. See *Straley* v. *Universal Uranium and Milling Corp.*, 289 F.2d 370, 373-374 (9th Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962) ("The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act"); *Moscarelli* v. *Stamm, supra; Carr* v. *Warner*, 137 F.Supp. 611 (D.Mass. 1955); *Nash* v. *J. Arthur Warner & Co.*, 137 F.Supp. 615 (D.Mass. 1955); *Goldenberg* v. *Bache & Co.*, 270 F.2d 675, 681 (5th Cir. 1959); *Belhumeur* v. *Dawson*, 229 F.Supp. 78, 86 (D.Mont. 1964) ("The defense of estoppel is available in a Securities Act case"); *Dale* v. *Rosenfeld*, 229 F.2d 855, 859 (2d Cir. 1956) (defenses of waiver and estoppel available in an action under section 12 of the Securities Act of 1933); *DeLamar Mines of Montana* v. *Mackay*, 104 F.2d 271, 274 (9th Cir. 1939). *Restatement, Torts* § 286 (1934), upon which implied civil liability for violation of section 7 of the 1934 Act has been predicated, states that liability arises only if

> "(d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action."

Petitioner's conduct goes far beyond that of the plaintiffs in any of the cited cases. Knowing full well the risks involved and the margin requirements he was violating, petitioner chose to assert his claim only when his speculations proved unprofitable. He had refused to protect

himself despite repeated warnings and requests by respondent's officers with respect to his indebtedness. He voluntarily assumed the risk of loss, and he cannot now be heard to complain.

II

The judgment below is in accord with this Court's decision in the *Perma Life Mufflers* case.

Petitioner refers to the decision of this Court in *Perma Life Mufflers, Inc.* v. *International Parts Corporation*, 392 U.S. 134 (1968) and argues (Petition 11-14) that under the authority of that case the Court should grant him recovery to further the public policy of the margin regulations, irrespective of his own conduct. The argument is premised on petitioner's assertions that the duty to comply with the margin requirements was imposed solely on respondent (Petition 11-12, 13-14).

Petitioner is in error in this contention. As a registered representative of the New York Stock Exchange, petitioner was charged by law and by his agreements with the Stock Exchange and his employers with the duty to observe and enforce the margin requirements—Regulation T—which applied to his conduct as a broker. When he procured loans in excess of the margin limitations and speculated with the proceeds, he violated Regulation T.

In a 1953 interpretation of its Regulation T, the Federal Reserve Board said:

> "§ 220.111 Arranging for extensions of credit to be made by a bank.
>
> "(a) The Board has recently had occasion to express opinions regarding the requirements which apply when a person subject to this part (for convenience,

called here simply a broker) arranges for a bank to extend credit.

"(b) The matter is treated generally in § 220.7(a) and is also subject to the general rule of law that any person who aids or abets a violation of law by another is himself guilty of a violation. It may be stated as a general principle that any person who arranges for credit to be extended by someone else has a responsibility so to conduct his activities as not to be a participant in a violation of this part, which applies to brokers, or Part 221 of this subchapter, which applies to banks." (12 C.F.R. 220.111)

Petitioner's violation of Regulation T is clear. In *Remar* v. *Clayton Securities Corp.*, 81 F.Supp. 1014 (D. Mass. 1949), the Court held that defendant, a broker, violated Regulation T by arranging an unlawful bank loan for one of its customers. Petitioner's conduct in this action is far more reprehensible than that of the defendant in *Remar*. Petitioner obtained the loans for his own account by false representations, rather than for a customer. *Matter of Sutro Bros. & Co.*, Securities Exchange Act Release No. 7052 (1963) is directly in point. That case dealt with loans to customers of a brokerage firm by factors, not subject to Regulation T or U. The Commission held that where a broker or registered representative "arranges" a loan from a factor for a customer in excess of the margin requirements, he violates Regulation T. The Commission also held that a registered representative violates Regulation T by obtaining excessive credit from a factor for speculation for his own account.

The principle announced in *Perma Life Mufflers* is inapplicable to the facts in this case. Plaintiffs in that case were dealers who had operated muffler shops under sales agreements with one of the defendants. This Court, in reversing the District Court and the Court of Appeals, de-

cleared that *in pari delicto* is not a defense in treble damage actions under the anti-trust laws.

Plaintiffs in *Perma Life Mufflers* were not *in pari delicto* in the traditional sense, as their participation in the illegal franchises "was not voluntary in any meaningful sense" and they "accepted many of these restraints solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity" (392 U.S. at 139). Thus, the parties were not "of equal fault", nor had the plaintiffs actually "violated the law in cooperation with the defendant" (392 U. S. at 153).

Unlike the plaintiffs in *Perma Life Mufflers,* petitioner is *in pari delicto* in the traditional sense. His conduct was not only a violation of Regulation T, but he induced the making of the loans by false representations and it was his misuse of the proceeds that caused the violation. Respondent granted the loans on the basis of petitioner's misrepresentations and its only wrong was in failing to discover his fraud. Respondent did not actively and knowingly instigate or participate in the violations. The Trial Court found that none of respondent's officers having anything to do with the loans had knowledge of petitioner's fraud. Petitioner was the active wrongdoer. Moreover, while the private treble damage suit was specifically authorized by Congress as a means of enforcement of the anti-trust laws, no such private right of action was enacted by Congress in connection with section 7 of the 1934 Act or the margin regulations. There is nothing to suggest that it was Congress' intention that traditional defenses such as *in pari delicto* should not be applicable in any implied civil liability.

In its opinion, the District Court considered the decision in *Perma Life Mufflers.* Applying the standard prescribed by this Court in *Perma Life Mufflers,* the District Court concluded that the overriding public policy of deterring excessive use of borrowed funds for speculation in the stock market would be advanced by refusing to confer a

windfall on an investor-borrower who obtains loans by false representations in the expectation that "he could keep the profits if his speculation proved profitable and have the lender bear the loss if the speculation proved unprofitable" (290 F.Supp. at 89).

III

The decisions below do not establish any general principle of law meriting review by this Court.

The District Court concluded on the basis of the facts adduced on the trial that the purpose of the law would be subverted by rewarding a party for knowingly violating the law for his own benefit. The decision rests on its particular facts. Determinations as to the impact of particular policies as applied in particular factual situations can be made only on a case-by-case basis.

Conclusion

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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